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AVIATION REGULATION: A TIME FOR CHANGE

JOHN W. SNOW*

REFORM of the commercial aviation economic regulatory system is one of the most important and controversial questions facing the aviation community today. It would not be an exaggeration to say that we are at a watershed for aviation regulation. Extensive hearings on the issue were conducted by the Subcommittee on Administrative Practice and Procedure of the Senate Judiciary Committee.¹ The Subcommittee has released its draft report which is a ringing criticism and indictment of the present regulatory system. The final report is expected soon. The Civil Aeronautics Board's special staff report on regulatory reform was recently completed.² It concluded that "protective entry control, exit control and public utility-type price regulation under the Federal Aviation Act are not justified by the underlying cost and demand characteristics of commercial air transportation."³ The staff report recommends substantial relaxation of present controls on entry and pricing. The Administration has submitted major legislation to overhaul the present system of airline regulation.⁴ Hearings on this legislation are expected to occupy a considerable amount of Congressional attention in the next few months. The present system of airline regulation is the product of a different era. While the needs and conditions on which airline regulation was first predicated

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¹ *Hearing on the Oversight of Civil Aeronautics Board Practices and Procedures Before the Subcommittee on Administrative Practice on the Judiciary*, 94th Cong., 1st Sess. (1975) [hereinafter cited as Kennedy Hearings].

² CAB, REGULATORY REFORM: REPORT OF THE C.A.B. SPECIAL STAFF (1975).

³ *Id.*, Executive Summary at 1.

⁴ S. 2551, 94th Cong., 1st Sess.; H.R. 10261, 94th Cong., 1st Sess. (hereinafter cited as the Aviation Act of 1975). See also, Aviation Act of 1975, Message from the President of the United States Transmitting a Draft of Proposed Legislation, H.R. Doc. No. 94-278, 94th Cong., 1st Sess. (1975).

nearly forty years ago have changed substantially, the goals, practices, and underlying approach of government regulation have not.

In 1938, when the Civil Aeronautics Act was passed, government assistance, through protection, subsidy, promotion, and economic regulation was regarded as necessary to nourish and foster the growth of an infant industry. In the intervening period, the airline industry has become a mature and important part of the nation's economy. Today it is the dominant mode of public transportation for intercity passengers.

Unfortunately, the regulatory system has not kept pace with the underlying technological change and economic growth in the industry. Former problems, such as public acceptance of air transport, have been largely solved. Today the major problems facing the industry are a product of regulatory practices which are badly out of date and do not advance the public interest in an efficient airline industry responsive to the public needs. Regulation now protects established firms from the forces of healthy competition.

The present system of airline regulation is seriously deficient. It results in a serious misallocation of resources; it causes air fares to be considerably higher than they would be otherwise; it discourages service innovations; it denies consumers the range of price and service options which they would prefer; and it creates a chronic tendency towards excess capacity in the industry.⁵ On review of the evidence one is forced to conclude that the present regulatory system is hindering, not advancing, the original statutory objectives of "adequate, economical and efficient service by air carriers at reasonable charges."⁶ The present regulatory system has become a major obstacle in providing air service "at the lowest cost consistent with the furnishing of such service."⁷

These defects result from the policies the CAB has adopted with respect to entry and pricing. They flow naturally from the artificial suppression of competitive market forces. The deficiencies can only be corrected by modification of the present regulatory

⁵ J. MILLER AND G. DOUGLAS, *ECONOMIC REGULATION OF DOMESTIC AIR TRANSPORT: THEORY AND POLICY*, Chs. 4, 5 (1974); W. JORDAN, *AIRLINE REGULATION IN AMERICA: EFFECTS AND IMPERFECTIONS*, Ch. 3 (1970); J. MILLER, *PERSPECTIVES ON FEDERAL TRANSPORTATION POLICY*, Part 2 (1975).

⁶ Federal Aviation Act of 1958 § 102(c), 49 U.S.C. § 1302(c) (1970).

⁷ 49 U.S.C. § 1482(e)(2) (1970).

system to allow wider operation of competitive market forces. The most pressing problems in the airline regulatory field cluster in three broad areas: rate making and pricing flexibility, market entry, and anticompetitive agreements.

On October 8, 1975, the Ford administration transmitted to Congress major legislation, the Aviation Act of 1975 (the Act), designed to correct the deficiencies in the present system of airline regulation by allowing wider operation of competitive forces.

The bill would achieve this objective by liberalizing entry, increasing pricing flexibility, and narrowing the Board's powers to grant immunity from the antitrust laws.⁸ Only through fundamental changes in the present law with respect to these matters will the airline industry be able to operate in a workably competitive fashion. Only allowing the industry to operate in this fashion will the basic defects in its performance be corrected.

In this article I shall discuss the impact of the current system of regulation on the airline industry's performance. The essential question here is whether airline regulation has encouraged an efficient allocation of resources responsive to public needs. After dealing with this issue, I shall discuss the Administration's proposal for regulatory modernization, the Aviation Act of 1975. I will argue that enactment of this legislation would significantly improve the economic performance of the air transport industry. Finally, I shall briefly review some of the major arguments which have been raised in opposition to regulatory modernization.

At the outset let me clearly state where I stand on these questions. I believe that the current system of airline regulation is deficient and that these deficiencies can only be cured by a substantial change in the policies of the Civil Aeronautics Board. I believe further that the Aviation Act of 1975 provides the correct approach to the problem and its enactment would significantly improve the performance of the airline industry. Finally, I do not believe that the critics of regulatory modernization have an intellectually valid case. The arguments for legislation to liberalize entry,

⁸ The principal entry provisions are sections 4 through 7, and section 9. Agreements are dealt with in section 12, and rates are covered in section 14 of the Aviation Act of 1975.

encourage pricing competition, and allow wider scope to the operation of market forces are, in my view, compelling.

I. THE RESOURCE ALLOCATION EFFECTS OF ECONOMIC REGULATION

Economic regulation of the airlines by the Civil Aeronautics Board takes a variety of forms, the most important being control over entry and pricing.⁹ The principal features and characteristics of the current regulatory system are as follows:

1. The Civil Aeronautics Board has restricted entry into the airline business. There were sixteen carriers operating when the 1938 Act took effect, and there has not been a single new trunk line carrier certificated in the Board's history. Through merger, the sixteen original trunk carriers have shrunk to ten and these ten now account for ninety percent of the total domestic market.¹⁰ As a practical matter, only those firms that participated in the industry when regulation was established, are now in it. The Board has, however, certified local service carriers, some of which are now as large as the smaller trunks, but locals have not become major competitive forces in the trunks' major markets.¹¹ Protection of existing carriers is also manifested in the Board's highly restricted attitude toward the charter carriers.¹²
2. The Civil Aeronautics Board by its grant of authority, limits the routes which each carrier may serve. Over the years the agency has significantly expanded most trunk carriers' route networks so that on most major routes they have some competition from another trunk carrier (and in some cases from local service carriers). But many smaller trunk carrier markets

⁹ Federal Aviation Act of 1958 §§ 401, 1002, 49 U.S.C. §§ 1371, 1482 (1970).

¹⁰ CAB, AIR CARRIER TRAFFIC STATISTICS at 4, 6 (1975) contains data for twelve months ending June 1975.

¹¹ CAB, THE DOMESTIC ROUTE SYSTEM: ANALYSES AND POLICY RECOMMENDATIONS 41-43 (1975); G. EADS, THE LOCAL SERVICE AIRLINE EXPERIMENT, Chs. 4, 5 (1972).

¹² Until recently, charter operations were allowed only on a restricted "affinity" basis, or for inclusive tours which required a minimum of three stops. Restrictiveness toward charters was significantly relaxed by adoption of new rules by the Board in August 1975. Under the new rule, one-stop inclusive tour charters (OTC's) are allowed. CAB Docket No. 27135, Regulation SPR-85, Part 378a—*One-Stop Inclusive Tour Charters*, adopted August 7, 1975.

are monopolistic and local carriers also serve many monopoly markets.

3. The Civil Aeronautics Board has seriously restricted pricing competition among airlines and has set fares with a view predominantly toward protecting the airlines' rate of return. In concept, the Civil Aeronautics Board attempts to assure a specified rate of return for carriers whose local factors are at or above a level set by the Board. In practice, the target rate of return has rarely been earned. Nevertheless, airlines have been able to attract sufficient capital with which to purchase aircraft to provide a level of service considerably above the target load factors.

4. The Civil Aeronautics Board does not put an upper limit on the amount of service that a carrier may provide on any of its certificated routes except where such route is covered by a capacity agreement that is sanctioned by the Board. Neither does the Board control expenditures on inflight service or other amenities offered passengers. Thus, while new entry is tightly controlled, carriers have substantial ability to compete through scheduling and service.

The regulatory environment briefly sketched out above has significantly affected the way the airline industry operates. Its principal impacts are:

A. The airline industry as a whole uses more resources to produce a given level of service (measured in terms of passenger and ton miles produced) than would be used if fares were set as a result of competition among airlines rather than by the Board. The excess use of resources takes several forms. Of particular importance, airline load factors are depressed because airlines compete through their flight schedules rather than through prices. An inverse relationship exists between fares and break-even load factors. The higher the established fares relative to the competitive level, the lower the break-even load factor.¹³ High fares encourage carriers to compete through flight schedules, and as long as fares are above a break-even load factor level, this service rivalry will cause average load factors to fall. Thus an important consequence

¹³ See J. MILLER AND G. DOUGLAS, ECONOMIC REGULATION OF DOMESTIC AIR TRANSPORT: THEORY AND POLICY 40 (1974).

of the absence of effective price competition is over-scheduling which produces excess capacity and low load factors.

Airlines have also been encouraged to engage in other forms of non-price competition. They provide service to travelers which appear to the travelers to be free. It is doubtful that the same quantity or quality of such services would be purchased if airlines charged for them. With price competition inhibited, competition tends to take a non-price form. Passengers find airlines competing for their patronage through elaborate cuisine, free drinks, attractive stewardesses, multi-colored planes, piano bars, and of course, schedule frequency. It is important to recognize, however, that this non-price competition occurs in markets where airlines are faced with competition, not in markets where regulation has limited entry so that airlines are monopolists. The sanctioning of capacity agreements by the Board is certainly a way to lessen some of the resource waste resulting from the absence of price competition, but it has more than offsetting deleterious effects.

B. As a result of the emphasis on service competition, excessive costs are incurred by airlines which are in turn passed on to consumers in the form of fares higher than would be the case if price competition existed. Because fares are higher as a result of the regulatory process, the quantity of service purchased is reduced. Thus everyone who flies pays more and some people who might fly at competitive fares do not fly at the higher fares.

In this regard, it is important to note that few people are enriched by the regulation. In the absence of capacity agreements, airlines compete away the potential gains resulting from the Board's unwillingness to allow price competition. And even in the presence of capacity agreements, the same tendency exists because relatively few routes are subject to capacity agreements and the airlines are in a position to switch aircraft to non-agreement routes and intensify competition in these markets.

C. Because the Board prohibits price competition but allows other forms of competition, airlines tend to provide a non-optimal mix of service to their customers. Airlines compete with each other with respect to flight frequency, passenger amenities, terminal facilities and the like. A consumer who wants to fly from A to B is forced to buy not only his seat but also a set of other services

which he might not purchase if given the option of a less costly flight at a lower price. This is not to say that no passengers would want to buy the meal that is now free, the comfort of a partially empty airplane, the privilege of the most convenient departure time, or the pleasure of being served by attractive cabin personnel. But many passengers would probably prefer a lower cost flight with fewer amenities, a flight that may be less conveniently scheduled, or that is more completely filled.¹⁴ All of the extra services are costly and cause the airlines to use resources that are valuable in alternative uses.

The misallocation resulting from the lack of price competition is sometimes quite visible and extreme. In the middle and late 1950's, airlines ordered replacements for their long-range aircraft such as the DC6B, and similar models made by Lockheed. The replacement aircraft were somewhat faster but a great deal more expensive to operate. Airlines were prohibited from charging a lower fare for flights on the slower and less costly 6B's than for the newer turbo-compound equipment. As a result, consumers preferred the latter type of aircraft and switched to them whenever possible. Not long after the introduction of the turbo-compound equipment, jets were introduced and the newest piston aircraft were phased out of service after only a few years' use even though some older piston aircraft with lower operating costs continued in use for additional years.

D. In an effort to inhibit non-price competition among airlines, or indeed to inhibit all forms of competition among airlines, the Civil Aeronautics Board over the years has established rules which cause the industry to act inefficiently. Examples are: closed door restrictions, which prevent carriers from providing service for local passengers; the long-haul restriction, which requires carriers to fly beyond their logical terminus; or the mandatory stop requirement, which prevents the carrier from providing direct non-stop air service between two points. In order to inhibit the growth of substitute services, the Board has severely limited the operations of charter carriers and it has also restricted the operation of commuter airlines.¹⁵ All of these restrictions by the Board tend to cause ineffi-

¹⁴ See W. JORDAN, AIRLINE REGULATION IN AMERICA 175-77, 200 (1970).

¹⁵ As to charter carriers, see note 12 *supra*. Many commuters operate without certification under authority of the Board's Part 298 exemption, 19 C.F.R. § 298.

encies in airline operations. They also cause people to fly at higher costs or accept a less desirable service than would be the case in a more competitive airline system.

E. It is likely that there has been a diminution or at least a reorientation of entrepreneurial endeavor. Rather than seeking to attract customers by offering that combination of services and prices best meeting their wants, the management of airlines must inevitably seek to provide a level of services which fits the regulatory climate. This affects the entire structure of the industry and diverts its management's attention to channels which in competitive industries would be viewed as non-productive.

II. THE AVIATION ACT OF 1975

The Aviation Act of 1975 is the Ford Administration's response to the problems associated with the present system of aviation regulation. The unifying theme of this legislation is the desirability of placing greater reliance on competitive market forces in the aviation industry. The major deficiencies associated with the present regulatory system—excess capacity, high air fares, and the limited range of price service options—all result from the Civil Aeronautics Board's suppression of normal competitive forces in the industry. The only corrective is a substitution of competitive market forces for traditional Civil Aeronautics Board policies towards fares and entry. Thus the heart of the Aviation Act of 1975 lies in the provisions dealing with entry and pricing.

A. Pricing

Increased pricing flexibility is essential to improving the performance of the aviation industry and the Aviation Act of 1975

The statutory basis for the exemption is § 416(c)(1) of the Federal Aviation Act, which permits the Board to exempt carriers from economic regulation if it finds that such regulation would be an undue burden on the carrier or class of carriers. The exemption is limited to carriers using small aircraft. The original maximum size was 12,500 pounds gross take-off weight, but this limit was amended in 1972 to a maximum of 7,500 pounds carrying capacity or a passenger capacity of 30. The Board has not encouraged such carriers to obtain certification. In fact, the Board recently turned down an application for a temporary certificate made by a Part 298 commuter carrier even though the Board had found that there was a need for the service sought, that a commuter carrier would provide the best service on the route, that the applicant was already providing reliable service on the route, and that failure to issue the temporary certificate might cause the termination of the service. *Application and Petition of Air Midwest, Inc.*, Docket 28262, CAB Orders No. 74-1-78 and 75-11-53.

is designed explicitly to obtain this objective. Under the bill, carriers would be given substantially more freedom to increase or reduce fares free from the fear of suspension. In addition, explicit time limits will be placed on Civil Aeronautics Board action in fare cases, and management will be given much greater freedom to reduce rates without fear that the rate reduction ultimately will be found unlawful.

The Civil Aeronautics Board's power to suspend or set air fares is statutory.¹⁶ The Federal Aviation Act of 1958 requires air carriers to file and observe just and reasonable tariffs. If the Board finds a rate unjust, unreasonable, unjustly discriminatory, unduly preferential, or unduly prejudicial, it may suspend the tariff. After investigation, the Board may determine and prescribe a different fare, or maximum or minimum charges, or both. The statute sets forth five factors which the Board must consider in determining the lawfulness of rates.

Under the statute, carriers are free to file fares with the Civil Aeronautics Board which are different from those of their competitors, and, in theory, this could create considerable pricing competition. As a practical matter, however, there is little real pricing competition. Airline fares have been generally uniform in all markets of equal distance, regardless of demand conditions, supply, seasonality, density, or costs.

Carriers who file tariffs reflecting moderate price decreases for particular types of service have had to answer to competing carriers who have generally complained to the Board that the rate reduction is unreasonably low. The cost, the uncertainty, and the delay of Board suspension proceedings has had a chilling effect upon individual carrier ratemaking initiatives. Because carriers anticipate the difficulty of obtaining approval, many reductions are never filed in the first place. Carriers facing rate increases in particular markets face the same problem. Often the Board will suspend and set for investigation such rates on its own initiative. Again, the cost of the investigation has a chilling effect upon carrier initiative. Carriers usually find it expedient to withdraw the rate or to await Board approval of a general fare increase.

The Aviation Act of 1975 is designed to increase carrier pricing

¹⁶ Federal Aviation Act of 1958 § 1002, 49 U.S.C. § 1482(g) (1970).

flexibility by reducing the regulatory hurdles to innovative pricing.

First, it would amend section 1002(d) to provide that a rate above "direct costs" may not be found unjust or unreasonable on the basis it is too low.¹⁷ Direct costs are defined as those costs which vary directly without output, *i.e.*, to exclude overhead, fixed costs, and non-variable costs. By limiting the Board's minimum ratemaking authority in this way, the Act provides for considerable downward pricing flexibility. The Board's present authority with respect to the ultimate lawfulness of rate increases is not affected.

Secondly, the Act amends section 1002(g) to create a no-suspend zone.¹⁸ Rate increases may be suspended but only if they exceed ten percent of the rate in effect one year prior to the proposed change. Rate decreases may be suspended but only if there is a clear and convincing reason to believe that they do not cover the direct costs of the service at issue or if the resulting rate decrease exceeds certain limits. In the first year after enactment, the Board may not suspend a rate which provides for less than a twenty percent decrease in the rate in effect on the date of enactment; and in the second year after enactment, the Board may not suspend a rate which provides for less than a forty percent decrease in the rate in effect on the date of enactment. Again, this zone relates only to suspensions, and does not affect the Board's authority to rule on the ultimate lawfulness of a rate. During the third and succeeding years the Board could not suspend any proposed rate reduction unless there was reason to believe on the basis of a preliminary finding that the rate was likely to be below direct operating costs. The direct operating costs criterion is a protection against predatory pricing. Moreover, the Federal Act of 1975 amends 1002(e) to place increased emphasis on the need for price competition as a means of promoting a healthy air transportation industry responsive to the public needs.¹⁹ Finally, the Act provides a time limit for rate cases.²⁰ If the Board has not completed its proceedings within 180 days of the time the rate was scheduled to take effect, the tariff goes into effect without further proceedings.

¹⁷ Aviation Act of 1975 § 14(a).

¹⁸ *Id.* § 14(c).

¹⁹ *Id.* §§ 4, 14(b).

²⁰ *Id.* § 14(c).

The foregoing changes in the Aviation Act will create considerable opportunities for increased pricing flexibility. This flexibility is a necessary condition to improve the performance of the airline industry. Problems of excess capacity, high air fares, and the narrow range of price service options are directly related to the absence of effective price competition in the airline industry. In intrastate markets, such as Texas and California, where entry and pricing have been less restricted, prices have been considerably lower than in comparable interstate markets.²¹ Similarly, commuter airlines, operating completely free of controls over entry and price, and using equipment which is more costly per passenger mile, tend to charge comparable or lower fares than regulated carriers on flights of similar distance.²²

The evidence is quite clear that many people would prefer lower air fares in exchange for the amenities and service levels afforded today. Many passengers would prefer the opportunity to select carriers based upon price; some would prefer high load factors, less frills, and lower fares; others are willing to pay for low load factor, more comfortable and more costly service. The suppression of price competition has prevented carriers from responding to such consumer desires with a variety of prices related to different quality service.

B. Entry

The Federal Aviation Act grants the Board wide discretion in determining entry and route awards.²³ Under section 401 of the Federal Aviation Act, the Board is given authority to determine which carriers may operate in scheduled interstate service and on which routes they may operate. The applicant must be found fit, willing and able to perform the service properly and the transportation must be required by public convenience and necessity. The

²¹ Kennedy Hearings at 102, 437, 446, 454, 1150.

²² COUNCIL OF ECONOMIC ADVISORS, STAFF STUDY, EVIDENCE ON REGULATED AND UNREGULATED AIR FARES (July 15, 1975).

²³ Section 401(d)(1) of the Federal Aviation Act of 1958, 49 U.S.C. § 1371 (1970), states that "The Board shall issue a certificate authorizing the whole or any part of the transportation covered by the applicant, if it finds that the applicant is fit, willing and able to perform such transportation properly and to conform to the provisions of this act and the rules, regulations and requirements of the Board hereunder, and that such transportation is required by the public convenience and necessity; otherwise such transportation shall be denied."

Board has interpreted the entry provisions of the Federal Aviation Act so as to create artificially high barriers to entry into the industry. Reducing the barriers to entry into the commercial aviation business is a second essential condition to improving its performance.

Increased pricing flexibility and liberalized entry go hand-in-hand. Thus any proposal relating to price must be combined with one relating to entry into air transportation markets. The two are indivisible. The present system of blockaded entry reduces the pressure on existing carriers to engage in price competition. This, in turn, contributes to the problem of high fares, low load factors, and excessively high costs. With the number of competitors essentially fixed, maximum fare and minimum quality of service regulation may be necessary. With liberalized entry and pricing, carriers will be under competitive pressure to provide a range of services desired by the public at prices which reflect the actual cost of producing the service. The threat of potential competition will police carrier behavior and provide the needed incentive for carriers in existing markets to keep prices at a level low enough to forestall entry of competitors. The Board has never recognized the importance of potential competition as a market policing device and, therefore, the threat of new entry has had at best an attenuated effect upon carrier behavior. Potential competition is a vitally important force in producing desirable market results, *i.e.*, in assuring that firms are diligent in proving the type of service and price/quality options that the public desires.

Given the oligopoly character of most major airline markets and the monopoly characteristics of many local service markets, relaxation of entry is essential to police the pricing flexibility provisions of the proposed Aviation Act. Pricing flexibility unaccompanied by entry relaxation would create a serious danger of one-way flexibility resulting in higher fares, exacerbation of the overcapacity problem, and an even poorer economic performance by the airline industry.

The Aviation Act of 1975 is designed to reduce substantially the barriers facing qualified firms who wish to enter into air transportations, expand into new markets, or offer new varieties of service. Enactment of the legislation, however, would not necessarily lead

to the addition of new carriers on each domestic route, nor even to the addition of new carriers on a majority of the domestic routes. The basic result would be the introduction of potential competition. The threat of potential entry will police and discipline market behavior and insure competitive market results. The liberalized entry will place firms at the edge of the market, able and ready to step into that market when consumers are dissatisfied with the existing service and price levels. Such dissatisfaction will attract new entrants, but the existing firms will have an incentive to price competitively and offer the type of price service options which consumers desire. Certainly there will be occasions when an outsider will come into the market. This will occur when the new entrant provides a type of service not available from existing carriers and in instances in which the new firm is simply more efficient than existing firms. The more important result, however, will be introduction of potential competition which in turn will produce more competitive results by existing firms. The proposed Act contains a number of provisions designed to reduce gradually but substantially the barriers to entry into air transportation while providing adequate time for existing carriers to rationalize their operations and adjust to the changing economic environment. I will briefly outline the Act's major entry provisions.

1. *Policy Changes.* The Board's present Declaration of Policy written some thirty-seven years ago, was framed in the context of an infant industry in need of protection rather than a mature industry capable of operating in a competitive environment.²⁴ The Board has, in the past, relied on its Declaration of Policy to limit competition.²⁵ Accordingly, the Aviation Act of 1975 proposes to revise this Declaration to stress the desirability of competition and to deemphasize the protection of established carriers.²⁶

2. *Procedural Changes.* The Board has often refused to hear applications and to render decisions within a reasonable period of time. Instead, it has used procedural motions to settle substantive questions.²⁷ The Aviation Act of 1975 deals with these matters by

²⁴ Kennedy Hearings at 19, 37, 680.

²⁵ *Additional Service to San Diego*, CAB Order No. 74-5-17.

²⁶ Aviation Act of 1975 § 4.

²⁷ From 1969 to 1974, the Board enforced a de facto route moratorium, pursuant to which it virtually refused to set for hearing application for new route

proposing procedural changes which would require the Board to hear and decide cases speedily.²⁸ To speed the disposition of cases the Board will be given the option of dismissing any cases it chooses not to hear. Any cases dismissed, however, shall be dismissed for cause and will be reviewable by the Court of Appeals—thus ending the practice of denying applications by inaction and leaving the applicant with no recourse to court review.

3. *Supplemental vs. Scheduled Service.* For years doubt has existed whether paragraph 401(d)(3) of the Federal Aviation Act was intended to prevent supplemental carriers (*i.e.*, charter carriers) from also applying for authority to provide scheduled service.²⁹ The Board has recently addressed this question and decided that a supplemental carrier could not hold operating authority as a scheduled carrier.³⁰ Partly as a result of this legal ambiguity, no supplemental carrier has ever been permitted to undertake scheduled service even though qualified in every other aspect. The Aviation Act of 1975 amends paragraph 401(d)(3) so that supplemental air carriers will be allowed to apply for authority to provide scheduled service.³¹

4. *Charter Service.* In the past, the Board has generally placed such strict limitations on charter services that its growth has been severely impaired.³² For example, prior to August 7, 1975, the only inclusive tour charter rule in effect contained a number of highly restrictive conditions. These conditions included: (1) the number of days required between departure and return; (2) overnight hotel accommodations at a minimum of three places, other than the point of origin, no less than fifty air miles from each other;

authority and generally denied applications for new competitive authority in cases already in progress. Kennedy Hearings at 540, 546, 553, 576, 582, 634, 674, 689, 696, 729, 730. Mr. Minetti, a member of the Board, testified that the Board's policy was not one of route moratorium. He also indicated, however, that in 1969, after several new routes had been granted, the carriers suggested a moratorium to have an opportunity to "digest the new routes they had received" and that the Board subsequently adopted a "policy of caution" in granting new routes. Kennedy Hearings at 652-53.

²⁸ Aviation Act of 1975 § 5.

²⁹ Application of World Airways for a Certificate of Public Convenience and Necessity, CAB Order No. 76-1-88 (1976).

³⁰ *Id.*

³¹ Aviation Act of 1975 § 6(a).

³² See note 12 *supra*.

and (3) a tour price which was not less than 110 percent of any available scheduled fare. The price of an inclusive tour was not based on the cost of the specific charter flight and the related ground accommodations, but on the price of an unrelated scheduled fare. This condition, taken in conjunction with the three stop requirement, severely limited the saleability of inclusive tour charter services.

Legislation presently before Congress (Senate Bill 421 and House Resolution 6625) would substantially broaden the availability of charter services. In response to this legislation and substantial public criticism, the Board has recently expanded charter availability on its own initiative.³³ The Aviation Act of 1975 incorporates the essential features of S. 421 in order to guarantee the continued availability of charter services which are not unduly restricted.³⁴ The liberalizing of charter rules is important for two reasons. First, there is no good economic reason to inhibit the provision of service which people are willing to buy and which can profitably be provided. Secondly, and even more important, the availability of charters as a viable alternative to travelers will provide a competitive check on the prices charged by airlines.

5. *Unserved Markets.* Under present law, a Board finding of public convenience and necessity is required even though the applicant is otherwise fit, willing and able to serve a particular market and service is not being provided by established firms. When qualified firms are prevented from offering service which established firms are not willing to provide, no useful function is served—not even the dubious function of protecting existing firms except insofar as their less desirable, round-about or indirect service may be protected. The Aviation Act of 1975 deals with this problem by requiring the Board to grant approval for qualified applicants wishing to provide non-stop service between points not receiving such service from certified carriers.³⁵

6. *Liberalized Exemptions.* In 1952 the Board exempted operators of small aircraft from the detailed economic regulation administered by the Board.³⁶ The original aircraft limitation, 12,500

³³ *Id.*

³⁴ Aviation Act of 1975 § 2.

³⁵ *Id.* at § 6(b).

³⁶ See note 15 *supra*.

pounds, was set at approximately half the weight of a DC-3—then the equipment operated by the Nation's major airlines. So long as they operated aircraft smaller than 12,500 pounds (approximately nineteen seats), commuter air carriers (also called scheduled air taxis or third level air carriers) were free to charge whatever price they wished to set and to operate where and when they chose.³⁷ In 1972 the Board increased the exemption to thirty passengers or 7500 pounds of payload.³⁸

The Aviation Act of 1975 liberalizes the exemption for commuter carriers by allowing them to increase the size of aircraft operated from thirty seats to fifty-five seats.³⁹ This provision will enable commuter carriers to purchase larger turbo-prop pressurized aircraft and should materially expand their scope of operations. These carriers will thus be able to improve service to small points not attractive to certified carriers.

While the foregoing changes will create a more efficient, adaptive, and responsive air system, we do not expect them to have a major impact on scheduled service in the principal city-pair markets where the bulk of air passengers are carried. The three provisions which I will discuss next are designed gradually but substantially to increase the extent of competition in major markets.

7. *Certificate Restrictions.* Over a period of years, the Board has attached numerous types of conditions and restrictions to the operating certificates held by air carriers. Viewed as a comprehensive whole, the primary effect of these restrictions is to protect the markets of established carriers by preventing other carriers from offering services they would like to provide. These operating restrictions have a particularly pernicious effect: they increase the operating costs (and/or decrease revenues) of the restricted carrier. Consequently they permit the restricted carrier's competitors either to increase costs or become poor marketers, or to earn monopoly profits. An example may make this clear. Suppose airlines X & Y compete in the A to B markets, but Y is required to fly to C whenever it serves A & B. Such a requirement can only serve a

³⁷ 14 C.F.R. § 298.11 (1975).

³⁸ CAB Order No. 72-7-61, *aff'd sub nom.* Hughes Air Corp. v. CAB, 492 F.2d 567 (D.C. Cir. 1973).

³⁹ Aviation Act of 1975 § 6(b).

purpose if it adversely affects Y's ability to compete with X over A B. As a result, X, though theoretically subject to Y's competition, would in fact be able to take advantage of Y's handicap in deciding on the level or type of service it offers. The Aviation Act of 1975 directs the Board to undertake a proceeding to eliminate all existing certificate restrictions within a five year period and specifically prohibits the Board from imposing any closed-door, single-plane service, mandatory stop, long-haul, or any other similar restrictions.⁴⁰ In phasing out existing restrictions, the Board will be directed to proceed carefully with an eye toward the effects on the carriers and the traveling public. The phasing of the restriction removal program is dictated by the desire to provide all existing carriers with adequate opportunity to increase their efficiency and adjust their operations to the requirements of a more competitive environment.

8. *Sale of Certificates.* The Aviation Act of 1975 provides that, after January 1, 1978, a carrier may sell, transfer, or lease any portion of its operating authority to another carrier so long as the purchaser is fit, willing and able to undertake the transportation and so long as the transfer does not diminish competition.⁴¹ This provision will enable carriers to rationalize their operating systems by the purchase and sale of operating authority. In effect, this provision provides an alternative to the normal public convenience and necessity entry route for qualified air carriers.

The pattern of routes currently served by most carriers reflect the erratic manner in which the Board has dispensed route awards and also the manner in which the original certificates were awarded, which had little to do with the then (1930's) existing airline economics. With new markets opened to service infrequently and sporadically, many carriers have felt compelled to apply for permission to provide service in numerous markets in the hope that they would receive authority to serve at least a few of them.

The Board has not always awarded routes to the carrier which would be most likely to enter and succeed under competitive conditions. Sometimes in seeking "balance" the CAB has made a route award to a carrier whose system was meant to be strength-

⁴⁰ *Id.*

⁴¹ *Id.*

ened by the award even though it might be a less effective competitor than another applicant. The resulting system of routes operated by many carriers is not conducive to efficient operations.

The proposed provision provides carrier management with the opportunity to improve their route network. This provision also provides an additional way for new firms to enter the business of scheduled air transportation. Any firm found to be fit, willing and able to provide air service by the Board may purchase route authority from an established carrier. In particular, this may be expected to help the supplemental air carriers who have for years sought to provide scheduled service. This provision will open markets for new firms and permit existing firms to rationalize their own systems. Since the transfer of operating authority will result in one carrier authorization being substituted for another, it will not increase the number of carriers authorized in any market unless an existing certificate holder is not using his route authority.

It has sometimes been argued that operating authorities should not be saleable because they are grants by government. This argument is a non-sequitur. Also it is in the public's interest that a monopoly, if granted, be used by the firm that will use it to serve best. If the right to purchase does not provide means of enhancing monopoly, and in this case it clearly does not because the government can always issue new certificates, then the one who values it most highly will also provide the best service. As a practical matter, I believe that certificates will not have significant values because the new grants of route authorities will, within a few years, be so widespread as to make route certificates valueless except for the goodwill that may occur to a carrier providing service.

9. *Discretionary Mileage.* To ensure a fully efficient air system, some measure of flexibility and entry will be needed in the long term in addition to that provided by the removal of current certificate restrictions. The final provision of the Aviation Act of 1975 dealing with entry is aimed at providing this flexibility over the longer term.⁴²

Following the completion of the certificate restriction removal program, the Aviation Act of 1975 will allow each carrier to provide a limited amount of scheduled service in addition to those

⁴² Aviation Act of 1975 § 9.

services specified in its operating certificate.⁴³ Carriers could use this authority for a gradual expansion and rationalization of their route systems. The expansion process will be gradual since the total amount of new authority created each year would be limited to approximately five percent of system operations. Following a period of satisfactory service in markets entered under the discretionary mileage rule, the points served could be added automatically to the carrier's operating certificate without cumbersome procedures.

The entry provisions of the bill serve a number of important objectives:

- a. Allow the development of low cost air service tailored to the needs of the market.
- b. Eliminate waste and inefficiencies associated with past CAB certification practices.
- c. Allow the threat of potential entry to police the pricing flexibility provisions of the Act.
- d. Insure competitive market behavior under which an appropriate mix of price/service options will be offered to the flying public.

Taken together with the pricing flexibility provisions of the Act, the entry provisions will allow competitive forces in the airline industry to set fares, determine service patterns, and police market behavior. In short, the Aviation Act's entry and pricing provisions will substitute the market place for the Civil Aeronautics Board's judgment on crucial issues of air fares and service levels.

C. Anticompetitive Agreements

A third broad area of present regulatory policy affected by the Aviation Act of 1975 is the Civil Aeronautics Board's grant of antitrust immunity to carrier agreements.⁴⁴ The Federal Aviation Act presently provides that all agreements among air carriers must be filed with the Board and that the Board must either approve or disapprove such agreements.⁴⁵ Once Board approval is given, agreements are immune to challenge under the antitrust laws. Most of the agreements filed with the Board are indisputably innocuous

⁴³ *Id.*

⁴⁴ Aviation Act of 1975 § 13.

⁴⁵ Federal Aviation Act of 1958 § 408, as amended, 49 U.S.C. § 1378 (1976).

and do not raise serious antitrust considerations. Nevertheless, some agreements, particularly agreements to restrict capacity, do have serious anticompetitive effects. The uneconomic and anticompetitive effects of such agreements are striking.

Capacity agreements reduce the principal form of competition in the airline industry-service competition through scheduling frequency. Because price competition is so heavily restricted by Board policy, the anticompetitive effect of such agreements is all the more harsh. Another result is lower quality service than that implied by the fare level.

By apportioning market shares among competing carriers, agreements substitute non-market forces for market forces which would produce a competitive and more economically sound result.

Agreements mask chronic problems of excess capacity. Because price competition is eliminated by uniformly set fares, service competition, most notably in the form of scheduling frequency, is all that remains. Frequent service means low load factors, substantial unused capacity, and high fares. By substituting artificial arrangements for market forces in reducing the unused capacity, the agreements neither allow lower fares nor, through attrition and reduced investment over time, do they result in a reduction in the number of available seats in the system.

Capacity agreements also affect carriers in the nonagreement markets. Since they apply only to certain markets, carriers divert otherwise idle planes to markets served by nonagreement carriers and spill excess capacity over into those markets. This distorts the decision-making process for allocation of equipment between markets.

Finally, capacity agreements reduce incentives for rational investment planning. Absent capacity reduction agreements, competitive market forces would reduce capacity by discouraging overinvestment and accelerating sale of surplus equipment. Because carriers can expect Board-sanctioned protection if they misjudge investment or disposal decisions, managements are less prudent in their initial decisions. With Board rescue available, usual disincentives to uneconomic decision-making do not operate.

Capacity agreements, therefore, perpetuate the very problem they were designed to solve and, by sheltering carriers from competitive

pressures, they undermine market forces, artificially inflate profits and fares, and discourage rational economic planning.

The proposed Aviation Act addresses the problem of antitrust immunity for fundamentally anticompetitive agreements by prohibiting pooling, capacity, price fixing, and other anticompetitive agreements while retaining the authority of the Board to approve agreements which are not fundamentally anticompetitive, such as agreements dealing with ticketing, baggage handling, equipment interchanges, and the like.

The bill provides for a new standard to be applied to business-type agreements which are not anticompetitive in character or are otherwise essential to the functioning of a sound transportation system. Under the new standard, the Board may not approve an agreement which adversely affects competition unless clear and convincing evidence exists that the agreement is necessary "to meet a serious transportation need or to secure important public benefits, and no less anticompetitive alternative is available to reach the same result." Thus agreements which serve valid transportation needs without serious anticompetitive risks could continue to be approved by the Board. We would anticipate no difficulty in obtaining approval of desirable business agreements such as interline traffic agreements, scheduling agreements at congested airports, equipment interchanges, reservation and ticketing arrangements, and technical assistance to foreign air carriers. Hundreds of such agreements are on file with the Board and, standing alone, they serve beneficial purposes with negligible anticompetitive risk. Because they might arguably be subject to antitrust challenge, we believe that retention of antitrust immunity for them is desirable.

D. Air Carrier Mergers

The present section 408(b) of the Federal Aviation Act provides that all mergers and other restructurings must be approved by the Board under a "public interest" test.⁴⁶ The Board's decision can then be reviewed in the court of appeals on a substantial evidence test in accordance with general review procedures. The amendment will retain the present section 408(b) for a period of thirty months after enactment of this bill with respect to any cases

⁴⁶ *Id.*

filed at the Board in that period.⁴⁷ Thirty months following enactment a new two-part procedure and a new substantive test will become effective.

The Act provides, in place of the "public interest" test, that all restructurings be judged initially by a standard similar to that used in the Clayton Act. Unlike the Clayton Act, however, there will be a weighing of the anticompetitive effects against the transportation convenience and needs of the communities. Specifically, the amendment provides that a restructuring may not be approved if it will result in a monopoly in any part of the United States or if its effect is any part of the country may be to substantially lessen competition or tend to create a monopoly, unless the Board finds the anticompetitive effects are outweighed by the transportation convenience and needs of the communities and such needs may not be met in a less anticompetitive manner.

This test will first be administered by the Board, as in the present procedure. The Attorney General, however, will have the option of seeking the review of the Board's decision either in the U. S. Circuit Court of Appeals on a "substantial evidence test" or in the U. S. Federal District Court on a de-novo basis. The Attorney General will indicate within a certain time which method of appeal he chooses. The Attorney General could not seek review in the Court of Appeals if an antitrust action were pending in the District Court.

If review were sought in the District Court, the amendment provides that the Secretary of Transportation must submit his written views directly to the court regarding the transportation aspects of the case. The Board may also intervene in the District Court proceedings to present its views. A merger may not be consummated before the Board acts and any judicial review is completed. Appeals from the District Court's decision could be taken directly to the Supreme Court under the Expediting Act as is the case with actions under the antitrust laws. Finally, this section will also provide that any merger case must be decided by the Board within one year of the date it was filed.

E. Abandonments

The Aviation Act of 1975 provides for a new abandonment pro-

⁴⁷ Aviation Act of 1975 § 11.

cedure.⁴⁸ At present, carriers are free to provide various levels of service, and may substantially reduce service without Board permission. To abandon service completely, however, the carrier must obtain approval from the Board in accordance with section 401(j) of the present act. Abandonment of service has not been a substantial problem in the airline industry, but by this amendment carriers would be assured that they would not be required to provide non-compensatory service.

The section would amend section 401(j) and provide that a carrier may abandon a route if:

1. the carrier has operated the route below fully allocated cost (including a reasonable return) for at least one year, except the Board may postpone the abandonment for up to one year;
2. the carrier has operated the route below direct costs for a period of at least three months—in this case there is no postponement; or
3. upon ninety days' notice if the carrier can demonstrate that service will be provided by another carrier.

An exception to the above occurs if a community or another public body agrees to provide sufficient payments to a carrier to ensure that carriers' revenues (including any subsidy) at least equal its fully allocated costs, including a reasonable return. In this case, the carrier may not abandon the route as long as the payments are made. Thus, continuation of service is left to the option of the affected community. This revised abandonment provision will not result in the loss of service at cities where federally subsidized service is provided by local service carriers since losses are made up by the federal government.

By providing opportunities for carriers to get out of unprofitable markets, the abandonment provision is a means to alleviate any internal cross-subsidies which may exist and to prevent internal cross-subsidies from becoming a major problem. We do not anticipate that the new provision will lead to a substantial increase in abandonments, but it is important that an appropriate abandonment standard exist, both to avoid internal cross-subsidy and to allow market adjustments to assure that a proper incentive exists to tailor air service to market demands. Carriers should not be forced to lose

⁴⁸ *Id.* at § 8.

money or operate on the basis that profitable routes subsidized those producing inadequate revenue.

F. The Arguments Against Regulatory Modernization

A number of arguments have been raised in opposition to regulatory modernization in general, and to the Aviation Act of 1975 in particular. Space limitations will not permit me to do more than discuss these arguments in a highly abbreviated form. The arguments cluster under essentially four broad subjects.

1. Enactment of the legislation will result in a severe reduction in service, primarily to small communities.
2. Regulatory modernization will create undesirably harsh competitive conditions, resulting in "cut-throat competition," and severe financial hardship for the airlines.
3. A closely related argument is that regulatory modernization will significantly increase the prospects of monopoly in the aviation industry.
4. The system works well and there is no need for reform.

1. Service to Small Communities

The federal subsidy to regional airlines is intended to provide for service to communities which generate so little airline traffic that the service is not self-supporting. The Aviation Act of 1975 does not change this subsidy program. Consequently, there should be no diminution in service to communities now receiving subsidized service.

The Civil Aeronautics Board has generally granted abandonment applications by trunk carriers if the airline has shown the service to be unprofitable. But some communities receive non-subsidized service from trunk airlines but generate insufficient traffic to defray the cost of this service. In part, trunk airlines provide the service because many travelers from these communities travel beyond the nearest hub on the airline's longhaul routes. To the extent that service is provided because the combination of feeder and longhaul service is profitable, there is no reason to believe that the Act will diminish airlines' incentive to provide non-subsidized feeder service since there will be no diminution in airline profitability.

It may be that some airlines provide unprofitable service to a few small communities because they believe it is politically prudent

to do so. The abandonment provisions of the Act will enable them to discontinue this service if they so desire. The argument that the Aviation Act of 1975 will cause substantial loss of service to small communities ultimately depends upon the existence of substantial cross-subsidy between aviation markets. Only if certain markets are generating excess profits will it be possible for firms to subsidize losses in other markets and still make a normal rate of return. There is not any theoretical or empirical evidence showing the existence of cross-subsidy for the trunkline carriers. As I have indicated above, service competition operates to eliminate excess profits on markets where rates are set above a breakeven load factor. Only when rates are set above a breakeven load factor in monopoly markets would we expect to see firms earning excess profits in those markets. This is the case in some markets served by regional carriers. Thus there may be some internal cross-subsidy in markets served by regional carriers but service in these markets is not jeopardized by the bill because the present subsidy program is not altered. The Air Transport Association submitted a study on this issue to the Administrative Practice and Procedure subcommittee in connection with that Committee's recent hearings on the aviation industry. The ATA study concluded that deregulation of the scheduled air transportation system would lead to a wholesale reduction in air service. This study is deficient for a number of reasons and its conclusions are not supported.⁴⁹ For our purposes here, suffice it to say that the ATA model assumes that each market is served by a single monopolist. It stimulates the behavior of an industry made up of monopoly carriers rather than an industry with a number of firms operating in a competitive environment. Under the ATA model, the industry would operate with extremely high load factors and extraordinarily high level of earnings—a situation which is vastly at odds with the competitive environment which the Aviation Act would produce. By simulating a monopoly, the model produces spurious results. The model fails to take into account such factors as the role of feeder traffic which provides support for longer haul flights and the role of plane positioning.⁵⁰

⁴⁹ For a devastating critique of the ATA study, see forthcoming report of the Kennedy Subcommittee and the CAB SPECIAL STAFF REPORT, REGULATORY REFORM (1975).

⁵⁰ The model produces some preposterous results, such as suggesting that

Scheduled commuter airlines provide substitute or competitive services to those provided by local service or trunk airlines to small communities. Approximately thirty percent of American communities now receiving scheduled air service receive such service solely from commuter air carriers. These communities tend to be smaller cities with relatively low levels of traffic, in many cases less than twenty-five passengers a day. If local service or trunk air carriers were to discontinue service to some communities because it is unprofitable, then commuter airlines, which operate equipment that is far more economical than that used by certificated airlines, will step in to fill the void: they have done so in the past and I expect they will continue to do so.

Due to the increased competition and pressure for lower air fares, service in many smaller markets is likely to increase because the level of demand will rise. The Texas and California experience indicates that where price competition has been allowed to exist, the result has been a substantial increase in the quantity of air service provided and used. In summary, I believe there will not be much abandonment because the subsidy to local carriers is continued, trunks have already been permitted to abandon unprofitable services, and low-cost commuter service has been and will continue to be an available alternative.

2. Cut-throat Competition

It is correct that the Aviation Act will increase competition with respect to rates but, as I have explained earlier in this paper, the airline industry does not suffer from a lack of service competition. There is no reason to believe the substitution of price competition for service competition will in itself lead to ruinous conditions in the industry, *i.e.*, a condition under which rates are chronically below fully allocated costs. It will lead to some restructuring of service patterns and it will rechannel the competitive efforts of airlines but will not alter their intensity.

To the extent that the added price competition will lead airlines to operate with fuller aircraft, some aircraft may be grounded. This

service will be dropped between Chicago and St. Louis, a market with over 1200 daily passengers. It also predicts that service will be dropped between New York and Baltimore, with over 600 passengers per day, and in the Dallas-Houston market with over 1,000 passengers a day.

is by no means certain, however, because the lower air fares may stimulate demand sufficiently to more than offset the effect of the higher load factors. To avoid any undue financial hardship, the entry and pricing provisions of the bill are phased over a long period. The pricing flexibility is phased in over three years and entry in stages over a much longer period. This is done in order to allow normal growth in the demand for air travel to absorb any excess equipment that might result from the fact that consumers will choose to fly fuller aircraft at lower fares.

In any event, there is no justification for the ruinous competition argument in the economic structure in the airline industry.⁵¹ The evidence suggests very strongly that the optimal size of firms will be sufficiently small so that there will be room for a considerable number of competitive firms in the industry.⁵² There are no significant scale economies in the industry and all of the presently certificated carriers appear to be larger than the minimum efficient size firm.

Since predatory competition entails certain short-term losses, a rational firm would engage in such conduct only when there existed a strong prospect of obtaining monopoly profits either by driving other firms from the market or by disciplining the market. Two conditions are essential for predatory pricing.⁵³ One, the predator firm must have superior resources which give it greater staying power to achieve the purpose of driving the rivals out of the market, and two, there must be high barriers to entry to enable the predator firm to recoup its losses. In other words, the prospect of eventually realizing monopoly profits from the predatory conduct must be good. When entry or re-entry can occur relatively easily whenever prices return to levels at or above cost, the incentive to engage in such behavior is eliminated. By reducing the barriers to entry, the Aviation Act of 1975 will also reduce the prospect of successful predation.

The experience of the California and Texas intrastate carriers certainly suggests that price competition in the airline industry does

⁵¹ See Testimony and Exhibits of the Dept. of Transportation, Phase 7, DPFI (August 25, 1970).

⁵² *Id.*

⁵³ See Areeda and Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975).

not have destructive results. The underlying economic characteristics of the industry along with the reduction in the barriers to entry resulting from the Aviation Act indicates that predatory pricing does not pose a serious problem in the airline industry. In addition, the Aviation Act of 1975 itself will prohibit rates below variable cost and, of course, remedies under the antitrust statutes or section 411 of the Federal Aviation Act which prohibits unfair competition will continue to apply.

3. *The Prospect of Monopoly*

Regulation has not increased the number of firms above the number that would exist under a less regulated environment. Indeed, the contrary is correct. Since there are not any significant economies of scale in the industry, one would not expect any natural tendencies towards monopoly. The entry restrictions have reduced the number of firms below the number that would otherwise be effective competitors. Consequently, there is no threat of natural monopoly in the industry and the application of antitrust principles will ensure that the industry becomes and remains competitive.

4. *The System Works, There is No Need For Reform*

This argument is no more valid than an argument that a six-cylinder automobile running on four-cylinders is running and should not be repaired. As I have discussed earlier in this paper, the system is not functioning as well as it should function and can be made to function more effectively. The proposed Aviation Act's purpose is to bring about improvements in the economic performance of the airline industry.